Moscow Financial Weekly

For the Week Ending February 15, 2002

Treasury Attache's office, US Embassy Moscow

Highlights This Week

- Revision in 1999 and 2000 GDP -- 5.4% and 9% respectively
- Audit Chamber to investigate PwC reports on Gazprom for endorsement of asset stripping
- Central Bank Chairman responds to Duma on drop in reserves, exchange rate
- Focus: **Implementing the New Money Laundering Regime**

Key Economic Indicators

Indicators	Level	% chg 1 week	% chg since Jan. 1
Ruble/$ (MICEX) UTS	R30.7644	0.18	2.27
Monetary Base*	R678.6 bln	1.97	-4.22***
CPI	NA	NA	3.82
International Reserves*	$36.6 bln	0.27	0.27
RTS Index (end of week)	293.55	-0.09	12.88
Refinancing rate	25	0	0

*For week prior

** % chg from the abnormally high seasonal level at the end of the year.

Economic Developments

Industrial production increased 2.2% y-o-y in January, continuing the trend of lower growth that began in the fourth quarter of last year. Month-on-month, production dropped by 7.5% though this is mostly the result of fewer work days. Production increased the most in the light metallurgy up 9.8%, and food - up 8% y-o-y. The weakest performers were those dependent on export markets, such as the ferrous meals, timber, and those reflecting a decline in domestic investment demand, such as machine production and light industry. While the trend seems to be drifting towards lower growth, it is important to note that seasonal factors may still be playing out and that the next several months' performance should provide a clearer picture.

As we previewed earlier, Goskomstat announced a **revision of historic GDP numbers**, with GDP growth for 2000 now 9% vs 8.3%, and 1999 GDP now 5.4% vs 3.5%. Goskomstat explained that it reweighted the impact of small and medium business on GDP, which accounted for the increases. The changes come surprisingly late but in substance are not all that surprising. Official GDP figures include estimates for the gray economy, much of it in small and medium buisness, whose accuracy is hard to estimate.

The **State Audit Chamber** announced that it would **analyze auditor's reports on Gazprom's financial transactions**, Gazprom's assignments to its auditors, and the way the auditors were chosen. The announcement followed quickly upon delivery of a report to German Gref, Minister for Economic Development and Trade, from minority shareholder William Browder, managing director of Hermitage Capital. The report alleges that auditors PriceWaterhouse Coopers gave their seal of approval to deals that stripped tens of billions of dollars worth of assets from the company. The allegations that PwC whitewashed Gazprom asset stripping have been around for some time. In fact, earlier Audit Chamber reports of Gazprom's books also found nothing amiss. The latest developments highlight the new political climate under Putin and the Alexei Miller team at Gazprom which are clearly focussed on recovering lost assets and shine a bright light on past transgressions. That this is taking the form of an accounting scandal at a big-five firm also fits nicely into the post-Enron environment.

Banking sector

In response to an official Duma inquiry into the sudden drop in **Central Bank reserves** in December 2001, Central Bank Chairman Viktor Geraschendo gave no new explanations for the sudden drop in the exchange rate and reserves, citing: 1) the norm for mandatory sale of export earnings was cut from 75% to 50% in August 2001; 2) external debt payments ($2.5 billion of government debt plus $2.8 billion of CBR's own debt to IMF); 3) higher demand for foreign currency from importers and households which caused capital flight to increase from $1.6 billion in Q3 to $5 billion in Q4; 4) excess budget spending at the end of the year which went in to the currency market.

However, Geraschenko failed to persuade Duma Deputies. Mikhail Zadornov, Deputy Chairman of the Duma Budget Committee, is convinced that reserves fell primarily because the CBR moved $700 million to a deposit in a Russian bank (apparently either for the knotty Czech debt settlement scheme exercised by RAO UES or a loan to Gazprom to pay its taxes) and because of unjustified interventions in the currency market. External debt payments could not be the cause for the decline in reserves, Zadornov said, because the last payment was made two weeks before reserves fell, on November 15. Zadornov said that given the worsening global economic situation this year, the CBR would be forced to choose between building up reserves and maintaining stability of the ruble.

The State Duma scheduled the next reading of amendments to the **Law on the Central Bank** for March 6. If the GOR does not deliver its version by that time, the Duma will consider its own older version. The main debate under this bill will be the proposed authority of the National Banking Council. CBR Chairman Geraschenko threatened to resign if NBC's powers are extended as suggested by the Duma draft.

Yuri Ponomarev, the head of Vneshtorgbank, once again addressed the issue of **VTB privatization** in an interview. VTB may start selling shares to private investors as soon as 2003, provided the bank's capital is reorganized by the end of this year, Ponomarev said. According to the current GOR-CBR privatization roadmap, the CBR would first sell a 40% stake in VTB to the GOR, and then EBRD or other foreign investor is supposed to buy an additional share issue worth 20% of VTB capital. However, Ponomarev noted, EBRD has not so far entered into official negotiations on this issue. When there are 3 stockholders in VTB capital, the bank will start working out privatization plans. One of the most important issues to be decided at that stage is whether to limit foreign participation in VTB capital or not. In any case, Ponomarev stressed, the state would retain a blocking stake in the bank until 2007. VTB is going to select through a tender one Russian and one foreign consultant to develop privatization strategies. There are already a number of entities willing to provide consulting services, Ponomarev said, including the EBRD, IFC, and Citibank. The latter is also interested in assessing VTB value.

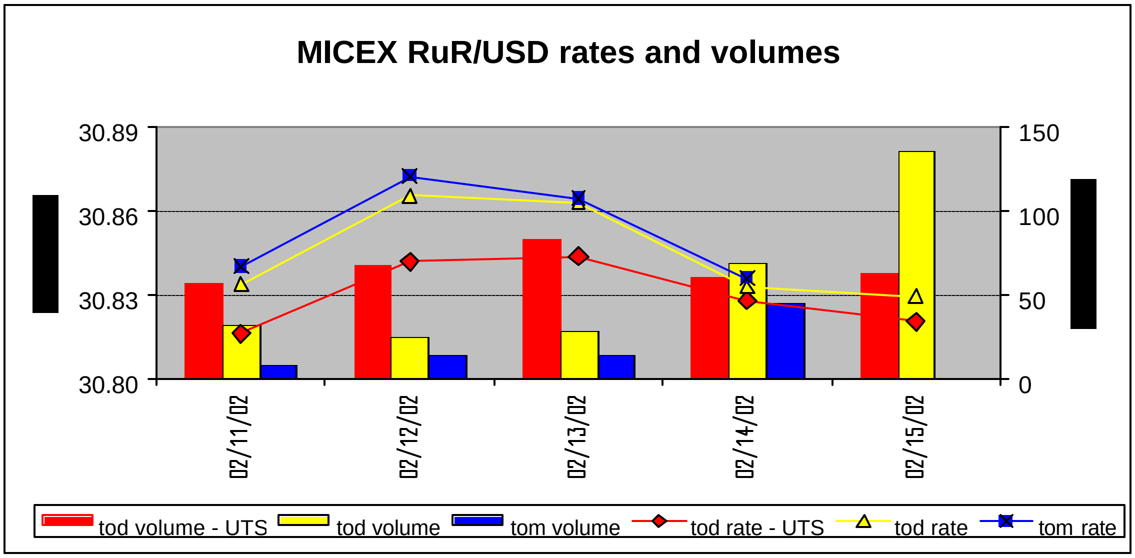
Rosbank and Bank MFK are going to "consolidate businesses," the heads of the two banks announced in a joint press conference on February 15. Shareholders have not decided yet in what form the consolidation should be done, but the new bank would retain the name "Rosbank" and offer a full range of banking and financial services. Both entities are controlled by Vladimir Potanin's Interros holding, with Rosbank becoming the bridge bank for UNEXIMbank after the 1998 crisis. At the beginning of 2002 Rosbank stood seventh in Russia both in terms of assets (R66.5 billion) and capital (R7.4 billion). MFK specializes in investment banking and is 41st in terms of assets (R6.1 billion) and 28th in capital (R2.3 billion).

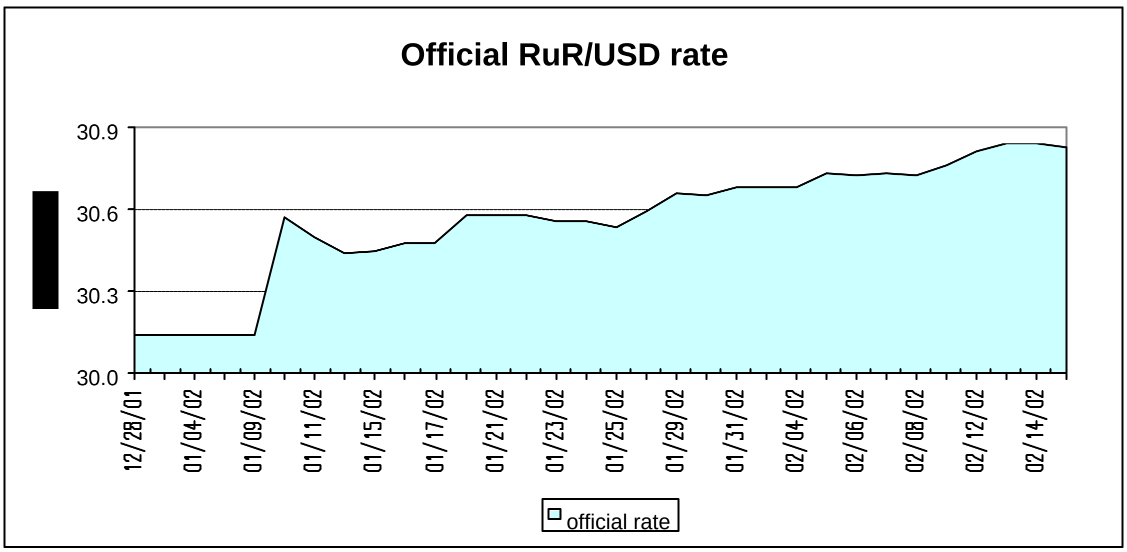
Financial markets

Forex Market

On Monday morning the CBR did not appear in the market and the ruble started rapidly weakening against the dollar, losing more than 5 kopeks in the UTS compared to the previous fix; in the first half of the week the ruble continued to weaken on thin volumes. On Thursday, anticipating ruble strain (in fact, on Friday the sum of balances in correspondent accounts with the CBR fell to the lowest level since February 2001) banks reduced demand for dollars and the weakening trend reversed. Quite remarkably, the CBR stayed away from the currency market all through the week.

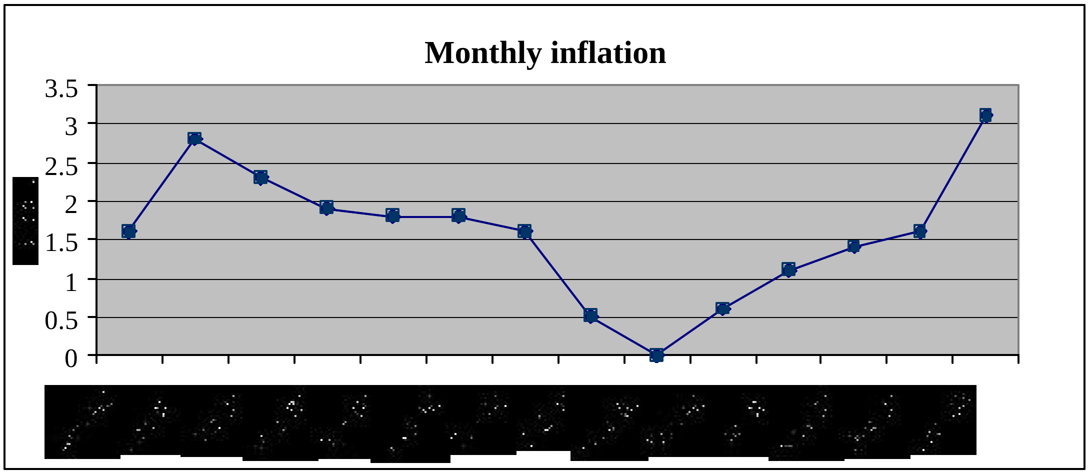
For the week, the ruble weakened 0.18%, closing in the UTS on Friday at 30.8206/$. MICEX weekly trade volumes were $333.29 million, $292.09 million and a mere $82.68 million for the morning (UTS), afternoon "tod" and "tom" sessions, respectively.





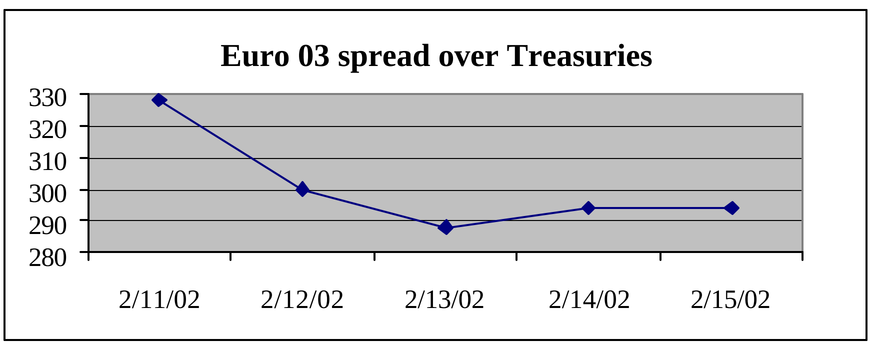
<u>Prices</u>

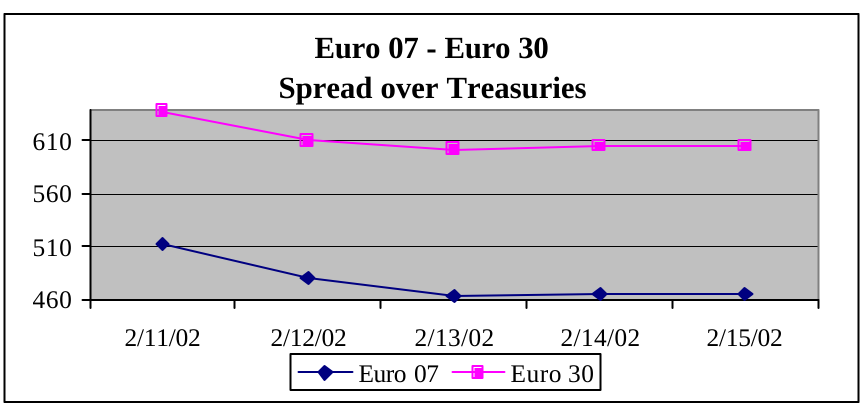
Inflation reached 0.7% during the first 11 days of February. During the week of Feb.5-11, growth in prices slowed to 0.4%. Since the beginning of the year inflation is 3.82%; though the trend appears to be slowing.



Eurobonds

Russian Eurobonds demonstrated stable growth last week. The market reacted positively to the good news from the US market, as well as positive dynamics in the world oil prices. Players were also inspired by the Finance Ministry and affiliated banks participation on the secondary market, buying MinFin 4 bonds.

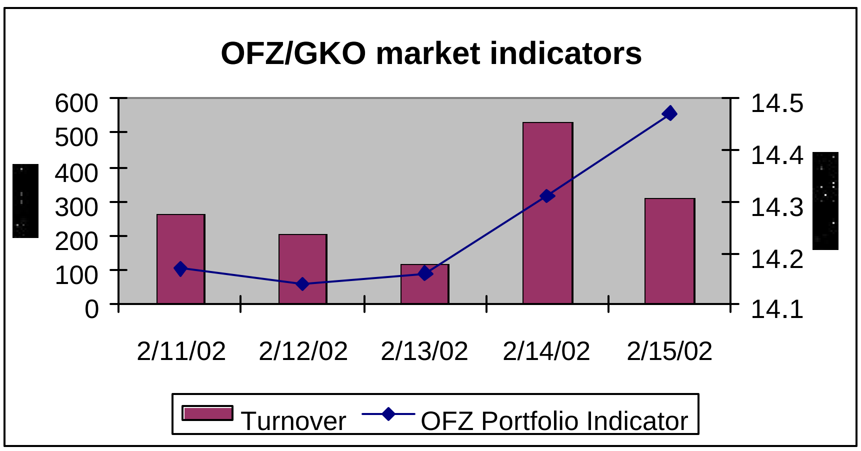




Interest/Bond Market

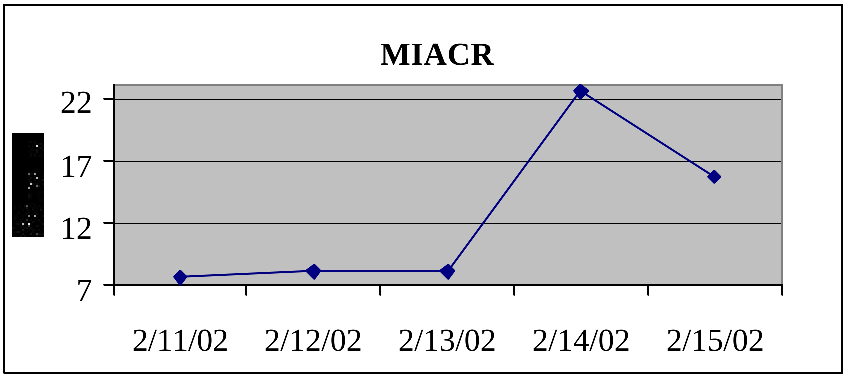
Bonds/Bills

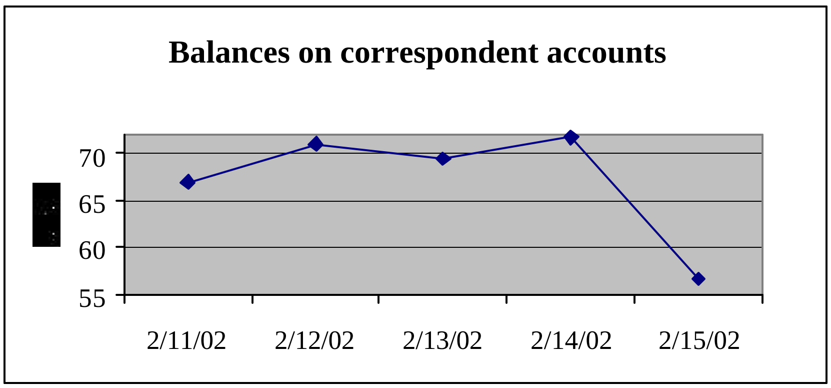
At the beginning of the week, the market was fluctuating in a narrow range of yields. During the last two trading sessions of the week, however, OFZ prices fell continuously on increased volumes. Several reasons could explain the sharp increase in yields on GKOs and OFZs. First, the market seemed to be reacting to the ruble deficit (note the sharp decrease in correspondent account balances this week at the Central Bank due to mid-month tax payments). Another reason could be non-residents selling paper to raise rubles for an S-account currency auction. Finally, market participants could be accumulating resources for the 6-month GKO auction that is to take place on February 20.



Overnight rates

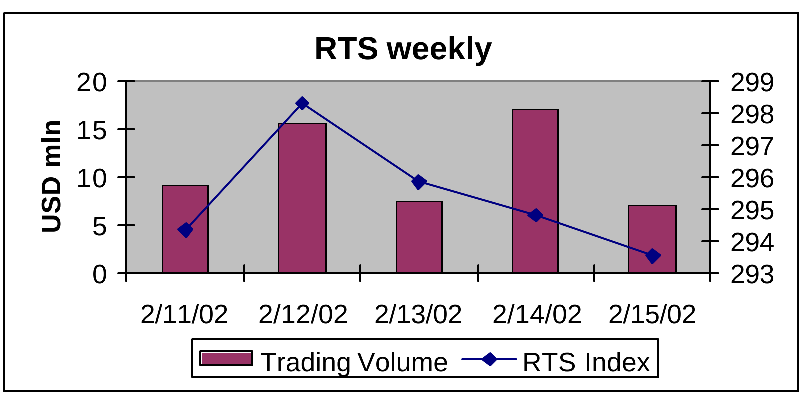
Tax payments caused a ruble deficit at the end of the last week. Balances on banks' correspondent accounts dropped to as low as R56.7 on Friday while overnight rates were up to 35%. However, by the end of the day, ruble liquidity eased.

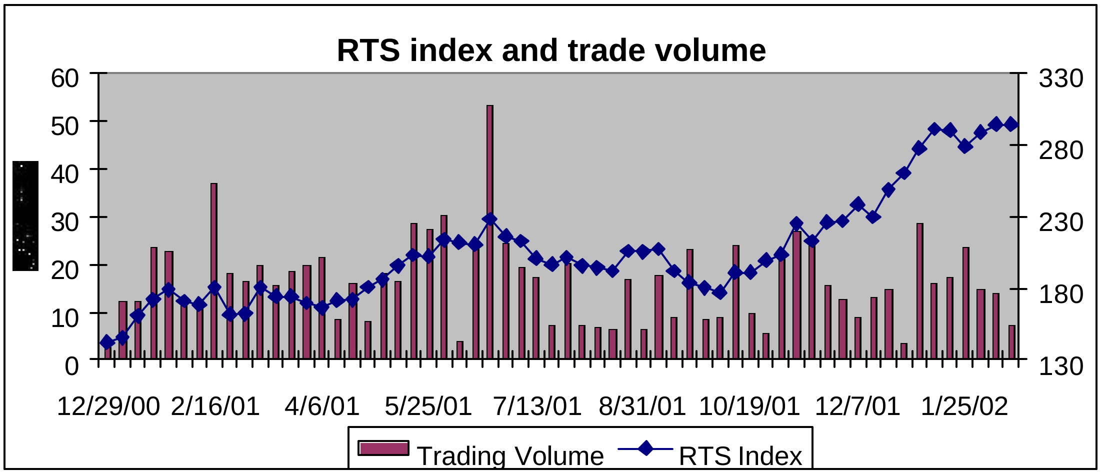




Stock Market

The positive trend picked up by the market on Monday, continued at a faster pace next day on the good news about world oil prices. The RTS index topped 300 before finishing at 298.32. Oil shares were among the leaders that day, although market participants are anticipating the release soon of 4Q01 results at which point trade volumes should increase. Unfortunately, this was the highpoint for the week. During the last three trading sessions, the market fell continuously on lower than average trade, ostensibly as investors sat on the sidelines absent any significant domestic news. For the week, the RTS index was 0.09% down in dollar terms.

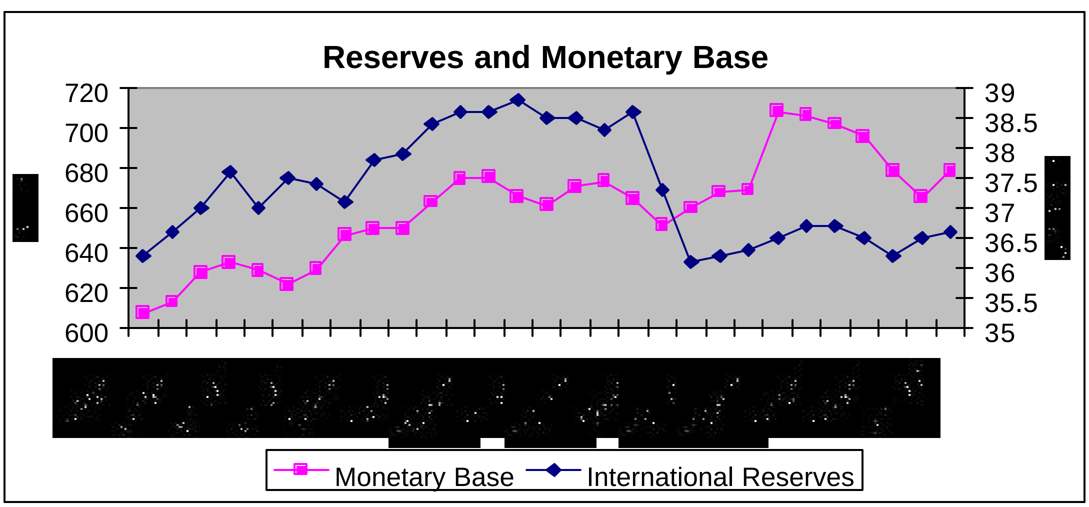




International Reserves and Monetary Base

International reserves were up by $100 million last week reaching $36.6 billion, which is $100 million higher than in the beginning of the year.

The monetary base was up for the first time in 5 weeks. For the week ending February 11, it finished at R678.6 billion - R13.1 billion higher than a week before. The Central Bank announced that M2 money supply (excluding foreign-currency deposits) expanded by 40% in 2001 to $54 billion, from $38.5 billion in 2000. This is a sign of improved financial intermediation in the economy, albeit from a very low base.



Implementing the New Money Laundering Regime

Russia's new anti-money laundering agency, the Financial Monitoring Committee (FMC), officially began work on February 1st. The path to this point was arduous. After years of infighting and internal resistance, it took the Bank of New York scandal and Russia's black-listing by the Financial Action Task Force (FATF) to finally create the political momentum to pass a money laundering law that meets international standards. Even once the legislation passed last July, the interagency battle continued over control of the anti-laundering agency (generally called the Financial Intelligence Unit or FIU), with the Finance Ministry eventually emerging as the victor. (The FMC is nominally independent but its chairman is also a First Deputy Finance Minister.)

The war on terrorism has now made money laundering an even higher international priority. Thus, as the new money-laundering agency becomes operational, it will face even greater scrutiny from abroad and pressure from its own government to meet emerging international standards on tracking dirty money. The two pressures – external and internal - are clearly related: a (perhaps "the") primary motivation for Russia's efforts is to get itself off of the FATF black list; however, to do this, it will have to show the outside world (especially FATF) that it has put in force a meaningful regime that can systematically collect, analyze and share information and, most importantly, seize assets and prosecute cases. The later will challenge entrenched interests and the capacity of the regulatory system to enforce rules on financial disclosure.

Making such a system work will not be easy or quick. Russia has a financial system where hiding information, has been developed in a high art form. The legal framework outside of the new money laundering law, reflecting a reaction to the Soviet system, severely limits the discretion of bank regulators and bankers to act or report on suspicion of wrong doing. The technical level of many banks is also quite low which increases the burden of collecting data. These factors would make it difficult for any agency in any country. For the new FMC, which has only modest budget financing and must deal with the potential for corruption within its ranks and in agencies with which it must cooperate, this is doubly true. This week we look at prospects for implementing Russia's new money launder regime.

Implementing the law -- what it means for banks

Though there has been a fair amount of press coverage of the money laundering issue in the past year, much of it has been of a hysterical or political nature (often reflecting the thinly disguised interests of the press organ's owner). There has been little about the real implications for banks and others of having to comply with the new law. Until last month banks could also afford to be blissfully ignorant. Recently however, the CBR has held a series of conferences around the country, designed to teach banks about money laundering and their obligations under the new law and conforming CBR regulations.

Teaching banks about money laundering is a bit like preaching to the choir – they have seen it all and more. But the reporting requirements under the new law are something very new. The conferences highlighted several issues:

- First, that this is a work in progress. The CBR itself could not answer many questions regarding contradictions with current law or what banks should do in specific scenarios. Nevertheless the answers got better as the days went by.

- Banks seemed to be focused on how to comply rather than on why they couldn't or how they could avoid doing so, which is positive. The main fear of banks seemed to be failing to report a transaction that would subsequently be caught in an inspection. Part of the problem is that the law itself provides room for interpretation. Banks must report on cash and other transactions in excess of R600,000 ($20,000). It also must report suspicious transactions that seem aimed to avoid the law, such as a series of transactions just below the legal limit. This more subjective standard caused confusion.

- Many banks are woefully unprepared to supply information digitally or even by fax. There were discussions about how they would transport reports to the nearest CBR office by car (though to our knowledge not by mule). This is a bad sign in terms of the efficiency of the system, but small, primitive banks will likely file fewer reports than larger banks.

- Some aspects of the law are clearly impractical and may need to be changed. The law requires reporting within 24 hours and admirable goal, but in the view of foreign experts, overly burdensome even for the most advanced banking system. The requirement in the U.S. is 15 days for large transactions and 30 days for other suspicious activity.

- For the time being the CBR is likely to remain as the intermediary between the banks and the FMC which will receive the data from the CBR and then process it. In most other countries the data is sent directly from banks to the Financial Intelligence Unit, but the CBR likely will jealously guard its position as sole regulator of the banking system. For the moment this is practical. In the future it may lead to conflict with the FMC.

Besides banks the law applies to securities brokers, insurance companies, money-changers, pawnshops, etc. These will be under direct responsibility of the FMC and may be harder to corral than the banks which are used to dealing with financial regulation and reporting.

Getting off the black list

Getting off of the FATF list will require not only that reports of suspicious be filed but that the data is processed and analyzed. This will be a difficult job but one that can be addressed with existing data-mining systems. The trick will be not to fall into the same trap as the CBR, which collects an overwhelming amount of data that, by most estimates, it fails to usefully analyze.

Working with law enforcement agencies will also be an important, though tricky, task. In other countries, law enforcement agencies can generally tap directly into the FIU's databases. However, given the deep concerns about corruption in Russian law enforcement which was a key factor in the debate over who should get the FIU, the FMC is likely to want to control access to information much more closely. Ultimately, however, the MVD, Tax Police or other law enforcement agencies are the only ones who can actually investigate and prosecute a money laundering case. It will be important that a basic level of trust be established that allows the FMC to work with these agencies.

Finally, at least in the minds of Russian officials, there is the political dimension. It seems clear that the instructions from on high are to do what it takes to get Russia off of the FATF black list as soon as possible, preferably by next June's FATF annual meeting. The experience of other countries creating new money laundering regimes, as well as the considered opinions of experts (including FATF members), is that this is an impossibly ambitious timetable. However, this did not stop the head of the FMC from proclaiming to the press recently that Russia expected to be off in June. There will certainly be an incentive to oversell actual progress, particularly when a FATF inspection team arrives. There also may be cause to bring outside political pressure to bear in the context of the Bush- Putin Summit or the G-8 Summit. Whether this has any effect remains to be seen. The reality is that Russia is probably better off focusing on real results and letting the question of the FATF list take care of itself. That will garner the most good will externally and make Russia a real player in the international anti-money launder system.

EXPLANATORY NOTES

1. **EXCHANGE RATES**: SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). "$-tod" price is the price of the dollar with same day delivery. "$-tom" is the price of the dollar with delivery on the next day. Minimum lot size for each of the dollar instruments is $100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

2. INTEREST RATES: Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

3. STOCK INDICES: The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

4. INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities, repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

5. MONETARY BASE (M1) is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

6. **LOMBARD CREDITS**, distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.